

***United States Court of Appeals  
for the Second Circuit***



**APPELLEE'S BRIEF**





ORIGINAL

77-5019

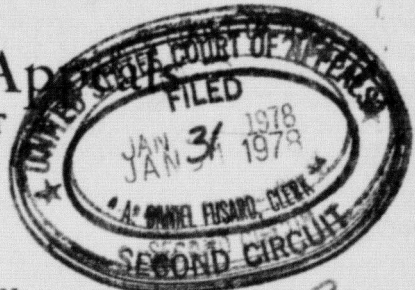
United States Court of Appeals  
FOR THE SECOND CIRCUIT

Consolidated Appeals.  
77-5019, 77-5022

In re

STIRLING HOMER CORPORATION,

Debtor.



GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for Mark Goldberg, and Mrs. D. WINDSOR DIXON,

Appellants,

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; and THE TRAVELERS INDEMNITY COMPANY,

Appellees.

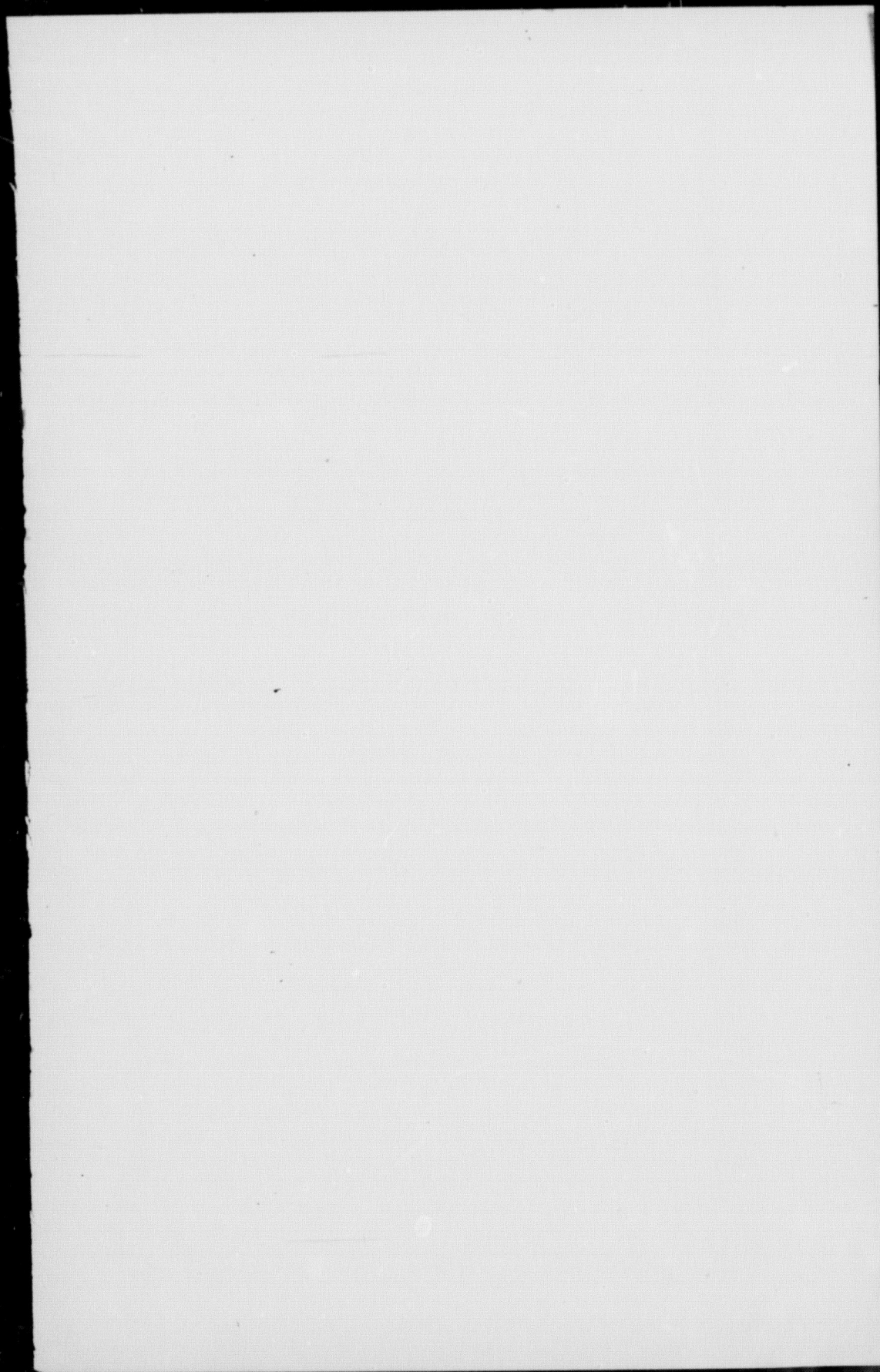
APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE  
WESTERN DISTRICT OF NEW YORK

**BRIEF OF APPELLEES CHEMICAL BANK AND  
THE FIRST NATIONAL BANK OF CHICAGO**

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## BRIEF OF APPELLEES CHEMICAL BANK AND THE FIRST NATIONAL BANK OF CHICAGO

These consolidated appeals from an order of United States District Judge Harold P. Burke dated July 27, 1977, and entered in these proceedings on July 28, 1977, were taken by

(i) “. . . Gregory Jezarian, Geraldine Jezarian and Lonetown Company, in their own behalf and in behalf of a class (or classes) they represent as certified in the action pending in the United States District Court for the Southern District of New York, titled “*Jezarian, et al. v. Csapo, et al.*, 72 Civ. 1671 (DBB), to wit, purchasers of securities of Stirling Homex Corporation between March 16, 1971 and July 10, 1972, and Harry E. Jones and Aleck Goldberg, as custodian for Mark Goldberg . . .” (A 449)<sup>1</sup>; and

(ii) “Mrs. D. Windsor Dixon in her own behalf and on behalf of all other stockholders of Sterling [sic] Homex Corporation similarly situated . . .” (A 447).

The order appealed from concludes a memorandum opinion of Judge Burke and provides that:

“ . . . in the exercise of discretion, the claims of allegedly defrauded stockholders are classified as subordinate to the claims of conventional general creditors.” (A 446)

for the purpose of a Chapter X plan of reorganization in the nature of a liquidation.

### Statement of the Issues

1. Where the assets of the Debtor in this Chapter X proceeding available for distribution to general unsecured creditors are approximately \$17,000,000, the claims of general unsecured creditors are approximately \$46,000,000, the Reorganization Court has entered an unappealed order adjudicating the Debtor insolvent and

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<sup>1</sup> “A” refers to the Joint Appendix, Volumes I and II.

directing that the Trustee proceed with an orderly liquidation in the Chapter X proceeding, was it error for the Court to classify "fraud claims" of present and former shareholders estimated at \$100 million as subordinate to the claims of conventional general unsecured creditors, where

(a) such "claims" were not timely filed pursuant to a Bar Order and are neither provable nor allowable in a liquidation bankruptcy, and

(b) there is no legal precedent requiring such "claims" to be classified on a parity with conventional unsecured creditors for a plan of reorganization in the nature of a liquidation?

2. Where the Jezarian, Lonetown and Dixon Appellants did not file their "fraud claims" within the time required by the Bar Order, did they have standing before the Reorganization Court at the classification hearings, and do they have standing before this Court?

3. Are the Jezarians, Lonetown and Dixon Appellants guilty of laches in failing to timely file their "fraud claims"?

4. A. Where the Jones and Goldberg Appellants did not appear before the Reorganization Court at the classification hearings, do they have standing as Appellants before this Court?

B. Did the action of counsel for the Jezarians and Lonetown in associating Jones and Goldberg and their counsel in his post-hearing memorandum constitute an appearance by Jones and Goldberg at the classification hearings?

5. Where (i) the Appellants, as shareholders of record, concededly received notice of the hearings before the Court which resulted in the unappealed order approving of the settlement agreement between the Trustee and the Banks and allowing the claims of the Banks as general unsecured creditors and determining their distribution rights, (ii) did not contend at the classification hearings that the al-

lowed claims of the Banks should be equitably subordinated to their "fraud claims" and (iii) they have asserted such issue for the first time on this appeal, should this Court entertain that contention?

### **Statement of the Case**

On July 12, 1972, Stirling Homex Corporation ("Homex") filed a petition under Chapter X of the Bankruptcy Act, as amended, and an order was entered approving of the petition; on July 13, 1972, an order of Judge Burke was entered appointing Frank G. Raichle as Reorganization Trustee. (A 1).

On July 21 and again on July 27, 1972, various wholly-owned subsidiaries of Homex similarly filed Chapter X petitions, orders were entered approving of the same and Mr. Raichle was appointed as Reorganization Trustee for each of the subsidiaries. (A 156).

The Chapter X proceedings of Homex and its five subsidiary corporations were subsequently consolidated into the Chapter X proceeding for Homex, and the assets and liabilities of each of the five subsidiaries were consolidated with the assets and liabilities of Homex as the surviving and continuing corporate debtor. (A 148).

On July 25, 1972, the Securities and Exchange Commission intervened in the proceedings and participated therein since that date. (A 156).

Homex was incorporated on July 22, 1968 and commenced business in August of that year as a modular home builder. (A 157). On July 12, 1972, when its Chapter X petition was filed, it had 10,097 uninstalled modules on hand, of which 9,259 remained to be sold by the Reorganization Trustee. (A 161).

Homex's operations had ceased on July 11, 1972 and were never started up again, due to a number of factors, one of which was that the concept of building modular homes on a production line basis and shipping them to prepared sites for installation had fallen into disfavor, and other companies engaged in modular home building were going out of business, one by one. (A 69).



In the years that followed, the Reorganization Trustee principally concerned himself, and admirably accomplished, the liquidation of substantially all of Homex's assets, including the inventory of modules on hand at the time the petition was filed (A 161) and audited the claims of various creditors. (A 161-74).

On April 18, 1977, the Trustee filed his report under Section 167(1) of the Bankruptcy Act. (A 154).

After his appointment, the Reorganization Trustee employed the firm of S. D. Leidesdorf & Co., Certified Public Accountants, to audit the books and records of the Debtor and its subsidiaries. (A 159).

The Leidesdorf report attached to the Trustee's Section 167 Report (A 176) reflects that as at July 11, 1972, Homex's consolidated assets, eliminating all material inter-company accounts and reflecting the carrying amounts of the assets on Homex's books of account, aggregated \$20,499,639; consolidated liabilities aggregated \$42,532,455. (A 176).

Homex's principal assets consisted of a Federal income tax refund claim in the amount of \$3,077,600, the inventory of unsold modules, carried at \$8,516,948, and property, plant and equipment at cost (less accumulated depreciation and a reserve for loss) in the amount of \$6,459,991. (A 176).

The principal liabilities of Homex reflected on the Leidesdorf report consisted of notes payable to banks aggregating \$37,431,973 and accounts payable, accrued expenses and sundry liabilities aggregating \$4,494,129. (A 176).

In his Section 167 Report, the Trustee concluded that Homex could not be reorganized and that:

"... any fair, equitable and feasible plan would involve an orderly liquidation of the Debtor's assets and a distribution of the proceeds among the Debtor's creditors." (A 174)

During the period of his administration from July 12, 1972 to March 31, 1977 the Trustee reported receipts

aggregating \$19,879,643, of which \$10,679,390 were derived from the sale of modules, \$3,221,761 on account of Federal and State tax refunds, interest income (apparently resulting from the Trustee's investment of surplus cash on time deposit) of \$2,665,469 and \$1,289,493 from sales of land, plant, machinery and equipment, furniture and other assets. (A 183). In that same period, the Trustee disbursed \$13,662,849, of which \$7,000,000 was paid to the Banks pursuant to his settlement (which will be discussed in detail hereafter) and \$3,018,078 represented salaries, wages and related expenses. (A 183).

By notice to creditors and stockholders dated April 28, 1977, the Trustee brought on two hearings, returnable on June 13, 1977: the first hearing sought a determination that Homex, the consolidated debtor, be adjudicated insolvent and that shareholders as such not vote on any plan of reorganization which might be adopted or participate in any distribution thereunder; the second hearing sought a determination whether stockholders who previously filed proofs of claim based on fraud or other securities law violations be included as general creditors for the purpose of participation in any distribution under any plan to be adopted. (A 149).

An accompanying order fixing date for hearings, etc., dated April 28, 1977, was made by Judge Burke which provided, among other matters, that a copy of that order, the Trustee's related application dated April 28, 1977, the Trustee's Section 167 Report and the notice of hearing be mailed to all (i) creditors of Homex enumerated in the list of creditors filed with the Reorganization Court on September 11, 1972 and all creditors who filed claims against the debtor even if not so enumerated; (ii) shareholders of Homex at the addresses listed therefor in Homex's records as at December 31, 1973, (iii) the Securities and Exchange Commission, (iv) the Secretary of the Treasury, and (v) the United States Attorney in Buffalo. (A 150-51).

Judge Burke's order further provided that a copy of the order fixing the date for hearings, the notice of hearings and the Trustee's application be published at least once a week for two successive weeks before May 23, 1977 in the

*Rochester Democrat & Chronicle* and the *Wall Street Journal*. (A 151).

At the hearings held before Judge Burke on June 13, 1977, there was received in evidence, as Exhibit 3, a document prepared by the Trustee entitled "Estimated Liquidation Distributions." (A 188). In Exhibit 3, the Trustee estimated a distributable estate before administration expenses, of \$16,986,376 (inclusive of the \$7,000,000 paid to the Banks under the settlement). The audited claims as at the date of the Exhibit, namely, June 7, 1977, aggregated \$45,961,000.

Exhibit 3 did not include any provisions for "claims" of shareholders of whatever type. The Trustee concluded that if the net distributable estate was \$14,000,000, creditors (based on his then current audited total) would receive a dividend of 30.46%; if the net distributable estate was \$15,000,000, creditors would receive a dividend of 32.64%, and; if the net distributable estate was \$16,000,000, creditors would receive a dividend of 34.81%.

#### **The Jezarians**

On or about April 24, 1972, Gregory Jezarian, and Geraldine Jezarian (collectively, "Jezarians") represented by Pomerantz Levy Haydek & Block, Esqs. commenced a class action based upon Securities Act fraud in the United States District Court for the Southern District of New York, against Homex, various officers and directors of Homex and Peat, Marwick, Mitchell & Co., Homex's auditors. (A 334, 335).

The class allegedly consisted of all persons who purchased securities of Homex between March 16, 1971 and March 20, 1972. The purchasers of securities were apparently Homex's common and preferred shareholders. (A 336); see also (A 410). Essentially, the original complaint of the Jezarians charged that between March 16, 1971 and March 20, 1972, Homex repeatedly issued financial statements and other reports which materially overstated its revenues, profits, assets and stockholders' equity and understated reserves and liabilities by improperly including in sales and receivables, transactions involving modu-



lar dwelling units, although the criteria which would permit the recognition of such transactions as sales and receivables had not been met, by improperly including in sales and receivables installation work on the percentage of completion method, by deferring rather than expensing research and development, project and production costs and expenses, by failing to set up adequate reserves and provisions for allowances for doubtful accounts and other losses, and by including in sales and receivables a sale of a parcel of land for \$2,100,000 which was not in fact a true sale. (A 338-39).

Prior to the June 13, 1977 hearings, Robert Block of the Pomerantz firm filed, as indeed he was required to do by Rule 10-211(a) of the Chapter X Rules, an attorney's statement dated June 10, 1977. (A 189-90). Based upon that attorney's statement, it appears that Gregory Jezarian purchased 25 shares of Homex's common stock on March 19, 1971 at a cost of \$675 and an additional 100 shares of the stock at March 23, 1972 at a cost of \$1,150. Mr. Jezarian sold those shares on or about May 17, 1972 for an unstated consideration. (A 189). Mr. Jezarian and his wife, Geraldine, jointly bought 50 shares of Homex's common stock at a cost of \$1,130.34 on or about March 22, 1971, which they hold at the present time. (A 189). Lonetown Company ("Lonetown") purchased 100 shares of preferred stock of Homex on or about January 6, 1972 at a cost of \$5,359.30, which it holds to date. (A 189).

Both of the Jezarians and Lonetown, in the attorney's statement of Mr. Block, claimed the cost of the shares. (A 190).

Mr. Block further disclosed that his representation of the Jezarians and Lonetown as "stockholder-creditors in this proceeding" arose out of their retention of his firm prior to April 24, 1972 in the case of the Jezarians, and prior to November 8, 1972 in the case of Lonetown, to prosecute claims for Securities Acts violations against Homex and others, "... in behalf of such persons and a class of persons similarly situated"; the retainer was oral. The class action previously described was brought and is pending in the United States District Court for the Southern Dis-

trict of New York, titled *Jezarian, et al. v. Csapo, et al.*, 72 Civ. 1671 (DBB).

Finally, Mr. Block disclosed that he was appearing in these proceedings

"... not only for the above mentioned persons [the Jezarians and Lonetown] but for the class they represent as duly certified in *Jezarian v. Csapo*, to wit, purchasers of securities of Stirling Homex Corporation between March 16, 1971 and July 10, 1972." (A 190)

A consolidated, amended and supplemental complaint in the *Jezarian* class action reveals that the class action was broadened to include all persons

"... who suffered injury in their purchases of securities of Stirling Homex Corporation . . . between October 7, 1970 and July 10, 1972." (A 418)

Homex was dropped as a defendant in the *Jezarian* action, allegedly "In obeisance to injunctive provisions of an order . . ." entered in the Chapter X proceedings. (A 419).<sup>2</sup>

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<sup>2</sup> The Chapter X Rules adopted by the Supreme Court of the United States became effective by order of the Supreme Court of the United States on April 28, 1975. Bankruptcy Act and Rules, 1976 Collier Pamphlet Edition, Part 2, p. 1005 (hereafter cited as "*Collier Act and Rules*, Parts 1 or 2, p. "). Rule 10-601(a) of the Chapter X Rules provides that a Chapter X petition shall operate as a stay of the continuation of any court proceeding against the debtor. A party may seek relief from the stay (Chapter X Rule 10-601(c)) by commencing an adversary proceeding pursuant to Chapter X Rule 10-701(5). The Advisory Committee's Note to Rule 10-601 explains that it supplements and reinforces the policies of Sections 11a, 113, 116 and 148 of the Bankruptcy Act. Prior to the effective date of the Chapter X Rules, stay orders were routinely issued under Section 116(4). The order dated and entered on July 13, 1972 approving of Homex's Chapter X petition and appointing Mr. Raichle as Reorganization Trustee, in paragraph 20, provided "That until final decree or the further order of this Court, all creditors and stockholders, . . . are . . . enjoined and stayed from . . . continuing any action at law or suit or proceeding in equity against said debtor . . ." (Record, Doc. #2, emphasis added). The order did not require any plaintiff in any pending action against Homex to drop Homex as a party defendant. In

(footnote continued on following page)

As previously observed, the Reorganization Trustee, as he was then required to do by reason of Section 196 of the Bankruptcy Act, obtained an order fixing time and manner of filing proofs of claim and stock interest, dated December 11, 1972 (the "Bar Order"). Paragraph 1 of the Bar Order required:

"All proofs of claim of creditors against the debtors or their property, of whatever character, *either in tort or in contract, fixed or contingent, liquidated or unliquidated*, other than those founded on . . . shares of stock, shall be filed with the Trustee of the debtors, . . . on or before February 19, 1973; . . ." (Emphasis added) (A 24)

The Bar Order required that a copy thereof be mailed by the Trustee to "all creditors and stockholders" at the addresses shown on the records of the debtors or as otherwise known to the Trustee and published, once during the month of January, 1973 in the *Wall Street Journal* and in the *Rochester Democratic and Chronicle*. (A 25-26). The Bar Order was mailed to each registered holder of common and preferred stock of Homex shown at the close of business, December 29, 1972 on the records of the transfer agent. (A 42).

As is shown by the statement filed by the Jezarians' counsel, both the Jezarians and Lonetown were shareholders of record of Homex's common and preferred shares and received the Bar Order. (A 190). Counsel for the Jezarians and Lonetown represented them continuously since at least April 24, 1972 in the case of the Jezarians and November 8, 1972 in the case of Lonetown. (A 190). The Jezarians and Lonetown still hold the common and preferred shares of Homex (A 189, 190) and, as such, received all notices required by the Reorganization Court to

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(footnote continued from preceding page)

point of fact, the practice in Chapter X proceedings *prior* to the enactment of the Chapter X Rules, allowed a party who had instituted a pre-petition litigation to apply for a modification of the stay to liquidate or determine his claims in other courts, even by means of jury trials. 6 *Collier on Bankruptcy* ¶ 3.30 at 647-49 (14th ed. 1977).



be mailed to shareholders during the course of these proceedings.

Notwithstanding the status of the Jezarians and Lonetown Company as shareholders of record throughout the course of these proceedings, and their continuous representation by Mr. Block of the Pomerantz firm prior to the commencement of these proceedings and at all times thereafter, it was not until December 21, 1976 that counsel for the Jezarians and Lonetown wrote to the Reorganization Trustee requesting that the Reorganization Trustee solicit once again claims arising from the purchase of common and preferred stock of Homex. (A 412, 413).

In that letter, counsel stated that until the settlement between the Trustee and the banks,

"... it appeared that priority [sic] claims asserted by Stirling Homex's bank-creditors would exceed the amount of distributable assets, so that general creditors would take nothing. In consequence, however, of your advantageous sales of the bulk of the bankrupt's [sic] inventory of unsold modules and of your settlement with the banks, whereby they have accepted general creditor status, the estate now presents an altogether different picture: \$15 million to \$17 million for distribution on \$50 million of filed general creditors' claims." (A 412)<sup>3</sup>

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<sup>3</sup> The statement that until the Banks made their settlement with the Trustee and accepted unsecured creditor status general unsecured creditors would receive nothing, was and is plainly wrong. The collateral claimed by the Banks consisted principally of security interests in inventory and receivables of Homex, and a pledge of all of the stock of Kabeth Properties, Inc., a debtor subsidiary for which Mr. Raichle acted as Reorganization Trustee (A 402).

At the hearings before Bankruptcy Judge Hayes held on May 10, 1976 with respect to the proposed settlement between the Trustee and the Banks, which counsel for the Appellants dismisses without any justification as "perfunctory" (Appellants' Brief, p. 12), it was plain that there were unencumbered assets of Homex available for distribution to unsecured creditors. Bankruptcy Judge Hayes inquired of the Trustee:

"... I take it from that that the security which the banks are seeking did not cover everything?" (A 100)

*(footnote continued on following page)*

### Jones and Goldberg

Milberg Weiss Bershad & Spechtrie, Esqs., counsel to Harry E. Jones and Aleck Goldberg, as custodian for Mark Goldberg (collectively "Jones and Goldberg"), timely filed a class "fraud" proof of claim on behalf of Jones and Goldberg on January 17, 1973 (A 27-30). In that claim, Jones and Goldberg affirmed that Homex was liable to it in the respective sums of \$3,968 and \$2,594.63, and that the consideration of the liability was the dissemination between February 17, 1970 and July 12, 1972 of false and misleading prospectuses, registration statements, annual reports and other documents allegedly containing misleading statements and omissions of material facts which overstated the income, assets, business and prospects of Homex and otherwise violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 promulgated thereunder as well as state and common law. (A 28).

The Jones and Goldberg claim further affirmed that in reliance upon the aforementioned misleading documents, each purchased securities of the Debtor in the open market and sustained losses and damages as a result thereof by reason of the reduction in value of the securities when the truth was disclosed. The claim further recited that:

"No part of the said debts or liabilities has been paid. There are no setoffs or count claims to said liabilities."

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*(footnote continued from preceding page)*

The Trustee responded:

"No, Your Honor. I should have made that clear. It did not cover plant No. 1, which is the main plant, and it didn't cover certain real estate, oh, some in Jamestown, some in Brockport, is it?" (A 101-02)

The Trustee received at March 31, 1977, \$1,289,493 in cash from sales of unencumbered assets and there remained to be liquidated, at June 7, 1977, approximately \$3,317,570 of other unencumbered assets consisting of furniture, fixtures, machinery and equipment, and real property.

Thus, there appears to have been over \$4,000,000 of unencumbered assets, i.e., not covered by the liens of the Banks, which were available to general unsecured creditors notwithstanding the settlement.

We simply cannot understand how the inattention of the Appellants to these Chapter X proceedings for almost five years can be justified.



Finally, the claim was filed individually on behalf of Jones and Goldberg and "... also on behalf of a class of persons similarly situated to the Claimants consisting of all other persons who purchased securities, common stock or otherwise, of the Debtor in the open market or otherwise, relying upon the misleading statements." (A 28).

Jones and Goldberg contended in their claim that the persons whom they claimed to represent were members of a class so numerous that joinder of all in the filing of the claim would be impracticable, that the filing of a class claim is superior to other available methods for fair and efficient adjudication of the controversy, and that the amount of damages sustained by the class was estimated at at least \$30 million. (A 29).

Jones and Goldberg attached to their proof of claim a copy of a class action complaint filed in the United States District Court for the Western District of New York titled "H. E. Jones and Aleck Goldberg, etc., Plaintiffs against David Stirling, Jr., et al., Defendants, File No. 1972-579," which set forth more fully facts with respect to their claims in the class claims. (A 29).

Jones and Goldberg executed a power of attorney in favor of the Milberg firm and two other attorneys located in Rochester, New York. Neither Jones and Goldberg nor their counsel appeared at the June 13, 1977 hearings or filed any pleadings. Counsel to the Jezarians and Lonetown added Jones and Goldberg to his *post*-hearing memorandum of law stating: "The Jezarian plaintiffs are joined in this submission by Harry E. Jones and Aleck Goldberg."

The Trustee filed his objections to the Jones and Goldberg proof of claim on April 23, 1974 (A 8, 31-32) and on that same day filed a motion to disallow the class nature of the claim. In an affidavit of David M. Brown, sworn to April 22, 1974 and submitted in support of the motion, Mr. Brown, as a member of the Reorganization Trustee's former counsel, noted the existence of nineteen class actions instituted in various federal district courts throughout the country involving similar allegations, the order of District Judge Dudley B. Bonsal dated December 1, 1972 entered in the Southern District of New York determining that one



such suit proceed as a class action, i.e., the *Jezarian v. Csapo* action, and further designating the class as comprising all purchasers of shares of the debtor between March 16, 1971 and March 20, 1972 (A 36-38).

Mr. Brown noted that the then new Bankruptcy Rules effective October 1, 1973 limited class action proceedings to "adversary proceedings" which did not include the filing of a proof of claim or objections thereto and sought a dismissal of so much of the claim as purported to be a class action claim. In a memorandum and order dated July 24, 1975, District Judge Burke disallowed so much of the Jones and Goldberg claim as purported to be filed as a class claim. (A 44-46). No appeal was taken from that order. (A 1-23).

#### **Mrs. Dixon**

Mrs. Dixon is another so-called shareholder-creditor who did not file a proof of claim within the period required by the Bar Order. She is a joint appellant from Judge Burke's order dated July 27, 1977 and according to her notice of appeal, appeals on behalf of herself and all other persons similarly situated and circumstanced. (A 447).

At the hearing on June 13, 1977, her counsel, Messrs. Bader and Bader, filed a statement under Bankruptcy [sic] Rule 10-211 (A 185) affirming that Mrs. Dixon "... intends to represent a Class of stockholders of the debtor", that she owns one hundred (100) shares of the preferred stock of Homex, that her retention of Messrs. Bader and Bader is oral and on the explicit understanding that Messrs. Bader and Bader will be compensated exclusively by any fee allowance that may be awarded by the Bankruptcy Court. (A 185-86).

On June 13, 1977, Mr. Bader sought to file a complaint instituting an adversary proceeding in these proceedings to determine whether "they" are defrauded stockholders and if there was a determination in that adversary proceeding that "they" were defrauded stockholders, "they should participate with general unsecured creditors *pari passu*." (A 236, 409). Mrs. Dixon was a shareholder of record from the commencement of these proceedings to the present

date and received all notices to shareholders of record that were mailed, as did the Jezarians, Lonetown, and Jones and Goldberg, including but not limited to, the Bar Order (A 24), the order fixing hearing and directing service dated April 5, 1976 with respect to the court proceedings for approval of the Trustee's settlement with the banks (A 52), as well as the order and notice of the hearing held before Judge Burke to determine insolvency and whether shareholders who previously filed proofs of claim for Securities Act fraud should be included as general unsecured creditors. (A 149-51).

### **POINT I**

**Under the facts of this case, the Reorganization Court properly subordinated the so-called "fraud claims" of present and former shareholders to the claims of general unsecured creditors for the purpose of a plan of reorganization in the nature of a liquidation.**

#### **In Answer to Appellants' Points I and II and the Argument of the Commission**

##### **1. The "Fair and Equitable" Rule**

The requirement that a plan of reorganization be "fair and equitable," as well as "feasible," is embodied in Chapter X of the Bankruptcy Act in two sections. The first, Section 174, provides that the reorganization judge, following certain specified hearings, shall enter an order approving a plan of reorganization which in his opinion complies with the provisions of Section 216 and which is "fair and equitable," as well as feasible.

Section 221(2) of the Act provides that the reorganization judge shall confirm a plan of reorganization if satisfied that the plan is "fair and equitable," as well as feasible.

Section 216 of the Act, referred to in Section 174, deals with provisions which must be embodied in a plan of reorganization under Chapter X.

Section 216(10) sanctions plans of reorganization in the nature of a liquidation by providing that a plan of reorganization may comprehend:

"... the sale of all or any part of its [the debtor's] property, either subject to or free from any lien, at not less than a fair upset price and the distribution of all or any assets, or the proceeds derived from the sale thereof, among those having an interest therein; ..."

See, *Country Life Apartments, Inc. v. Buckley*, 145 F. 2d 935, 938 (2d Cir. 1944).

A plan of reorganization in the nature of a liquidation, as well as a plan of reorganization for an ongoing company, must be "fair and equitable," as well as feasible.

"Fair and equitable" are words of art stretching back to the days of equity receivership reorganizations, and is a rule of "full or absolute priority," requiring creditors to be paid or provided for in full over shareholders in reorganization plans. *Case v. Los Angeles Products Co., Ltd.*, 308 U.S. 106, 115-121 (1939); *Northern Pacific Railway Company v. Boyd*, 228 U.S. 482, 504 (1913).

In *Kansas City Terminal Railway Company v. Central Union Trust Company of New York*, 271 U.S. 445, 455 (1926), the Supreme Court stated that:

"... to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation."

## 2. Classification of Claims and Stock

The first sentence of Section 197 of the Bankruptcy Act provides that:

"For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock."

Section 216(8) of the Bankruptcy Act permits a plan of reorganization to provide for non-assenting classes of



shareholders who are affected by the plan of reorganization, provided

“... That such protection shall not be required if the judge shall determine that the debtor is insolvent; ...”

In the appeal at bar, the Reorganization Court entered an order dated June 13, 1977, from which none of the Appellants have appealed, determining, finding, ordering, adjudging and decreeing that:

(i) the fair value of the assets of Homex, as a consolidated debtor, was \$16,986,376;

(ii) the amount of “debts” of Homex, as a consolidated debtor, was \$45,961,000;

(iii) Homex, the consolidated debtor, was insolvent “... and the stockholders have no equity in said consolidated debtor and are not entitled to vote on a plan or share in the distribution of the proceeds of the liquidation of the assets.”; and

(iv) Homex, the consolidated debtor, shall continue in reorganization under Chapter X to enable the Trustee to prepare and submit *a plan in the nature of an orderly liquidation of the remaining assets of the consolidated debtor*, which plan shall be prepared and presented in accordance with orders of the Reorganization Court. (A 21, 266-68).

The order of the Reorganization Court under review classified claims for the purpose of the orderly liquidation as required by the June 13, 1977 order.

Although an order has not been formally entered under Section 102 of the Act directing that bankruptcy be proceeded with pursuant to the provisions of Chapters I to VII, a “fair and equitable” plan of reorganization in the nature of a liquidation should classify claims and debts according to their provability and allowability under Section 63 of the Bankruptcy Act. See *In re Sixty-Seven Wall Street Restaurant Corp.*, 23 F. Supp. 672 (S.D.N.Y. 1938), where the reorganization court concluded that while former

Section 77B (k), which provided that Section 64 (dealing with priorities of claim) shall not apply to reorganization proceedings unless and until an order of liquidation had been entered (*compare* present Section 102), it nevertheless had the discretion to interpret former Section 77B (k)

"... as leaving with the court (unless and until liquidation becomes necessary) a discretionary power to classify claims and to grant preference as the facts of the particular case may require." *Id.* at 673.

If claims are not classified according to their provability under Section 63 for a "fair and equitable" liquidation, a fundamental unfairness and inequity to conventional general unsecured creditors will result. The type of plan of reorganization in the nature of a liquidation contemplated by Section 216(10) of the Act has as its underlying rationale, the effort to realize going concern values of assets for creditors and perhaps stockholders. Otherwise, the liquidation should be had under Chapters I through VII of the Act. *See*, 6A *Collier on Bankruptcy* ¶ 10.02 at 13-14 (14th ed. 1977). *Compare In re Porto Rican American Tobacco Co.*, 112 F. 2d 655 (2d Cir 1940), involving the purchase of all assets of debtor by a third party and distribution to creditors and shareholders of the third party's notes and, *In re Central Funding Corporation*, 75 F. 2d 256, 259 (2d Cir. 1935) involving the carrying on of the same business conducted by the debtor by a new company for a long enough period to permit the new company to advantageously liquidate the assets.

In the case at bar, substantially all of the Debtor's assets have been liquidated into cash by the Trustee. The remaining assets can be readily disposed of and this insolvent estate wound up since there are no going concern values which need be preserved by any further long term liquidation held under the auspices of Chapter X of the Act.

There is no reason why the orderly liquidation of Homex could not be concluded in a straight bankruptcy proceeding under Chapters I through VII of the Act.

Chapter X Rule 10-308 provides that the court shall enter an order, after a hearing on notice, dismissing the

case or adjudicating the debtor a bankrupt if it has not been previously so adjudged or directing that the bankruptcy case proceed (if a prior bankruptcy proceeding was pending), whichever may be in the best interest of the estate and appropriate, under any of the five subdivisions contained in Rule 10-308(a). Unless Judge Burke's order is affirmed, conventional general unsecured creditors will be lumped together with perhaps thousands of present and former shareholders whose alleged fraud claims total \$100 million, and the conventional general unsecured creditors will be effectively deprived of voting against a plan of reorganization in the nature of a liquidation so as to provide a statutory basis for adjudicating the Debtor a bankrupt and directing that the bankruptcy case proceed under Chapters I through VII of the Act. This would be most unfair and inequitable to general creditors, for unless the order appealed from is affirmed, claims not provable under Section 63 of the Act would participate and share in the assets of an insolvent corporation which, in reality, has been nothing more than a liquidation since the day the Chapter X petition was filed. No operations of the Debtor were ever resumed and the Trustee's efforts, successful as they have been, simply involved a constant liquidation of assets of a company which was part of an industry which apparently is no longer an industry.

*Collier* states that the function of classification under Section 197, gives the Reorganization Court:

"... a discretionary power of classification to be exercised as the exigencies of each individual case require." 6, Part 2, *Collier on Bankruptcy* ¶ 9.10, at 1596 (14th ed. 1977).

The discretion is to be guided by principles enunciated in federal equity receivership cases, given statutory sanction in Section 115 of the Act, but limited by the fixed principle or absolute priority rule which governs all reorganization plans in determining whether they are "fair and equitable." *Id.* at 1596-97.

The Reorganization Court in the case at bar had the discretion (if not the legal duty) under Section 197, and properly exercised that discretion, in directing the Re-



organization Trustee to proceed with a plan of a liquidation and to deal with the type of claims which would be provable under Section 63 of the Act in a liquidation bankruptcy, notwithstanding the definition of "claims" contained in Section 106(1) of Chapter X. Therefore, he properly subordinated the "fraud claims" of shareholders to the type of claims which are provable and allowable under Section 63 of the Act. (This is what we believe the Reorganization Court meant in the case at bar, in directing that the claims of the allegedly defrauded stockholders be classified as subordinate to the claims of "conventional general creditors." (A446)). Indeed, it is submitted that since a plan was to be submitted for the final and complete liquidation of Homex, it would not have been "fair and equitable" to do otherwise.

The "fraud claims" of the Appellants in the appeal at bar are not provable under Section 63(a) of the Act, based as they admittedly are, on the affirmative Securities Act fraud of Homex. *In the Matter of Frank J. Crimmins*, 406 F. Supp. 282, 286 (S.D.N.Y. 1975).

The main thrust of Homex's fraud, as charged by Jones and Goldberg in their proof of claim (A 27-28), and alleged by the Jezarians in their original complaint (A 334), were the willful acts of publishing materially false financial statements which overstated Homex's revenues, assets, profits and stockholders' equity, and understated reserves and liabilities. (*See also*, A 269-73).

Judge Conner in *Matter of Crimmins*, *supra*, stated that a cause of action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and the cognate Rule 10b-5, is one sounding in tort, citing *List v. Fashion Park*, 340 F. 2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). (406 F. Supp. at 286). Reading Section 63, Judge Conner found the dividing line of provability is between contractual and quasi-contractual claims which are provable and, therefore, allowable, and all claims sounding in tort which are neither provable nor allowable, with the sole exception of claims based on negligence.

The bankrupt Crimmins had been an officer of a now defunct brokerage company and had induced certain pur-

chasers to buy common stock of Four Seasons Nursing Centers of America, Inc. by misrepresentation and non-disclosure of material facts. In denying the provability and, hence, dischargeability of a claim by certain of the purchasers, Judge Conner found "the tort alleged was preponderantly a willful one." (*Ibid.*)

One must consider the filed claims of Jones and Goldberg against the debtor Homex and the tenor of the class action led by the Jezarians against the Debtor as charging a willful fraud.

The order subordinating the claims of defrauded shareholders in a plan of liquidation was a proper exercise of discretion for another reason. This proceeding has been pending for five and a half years, the Reorganization Trustee is prepared to wind-up the estate, and is left with only three employees at the present time. (Reorganization Trustee's Brief, p. 31) The class actions antedate the Chapter X proceedings and are still only in their discovery stage. On these facts, the Reorganization Court did not abuse its discretion in subordinating the "claims" of Appellants, for to allow those claims would unduly burden and delay the winding up of the estate of Homex. *In the Matter of Cartridge Television, Inc.*, 535 F. 2d 1388 (2d Cir. 1976).

Section 102 of the Act does not disable a reorganization court from considering Section 57d of the Act, that unliquidated or contingent claims should not be "allowed" if such liquidation or estimation "... would unduly delay the administration of the estate or any proceeding under this Act."

*Cartridge Television* is relevant for two reasons. First, this Court affirmed the lower court's refusal, based upon Section 57d in a liquidation proceeding, to refuse to postpone distribution of an estate ready to be wound up until similar "fraud" type claims of shareholders could be adjudicated. *Id.* at 1390. The Reorganization Court in the appeal at bar did not abuse its discretion by subordinating the "fraud claims" of shareholders to achieve a similar result in what is the equivalent of a liquidation bankruptcy ready to be closed up.

Secondly, and having regard for the fact that a plan in the case at bar will of necessity be a liquidation, this Court said in *Cartridge Television* that:

"by making contingent and unliquidated securities fraud claims both provable and non-expungable, appellants' position would weaken severely the priority position of general creditors. Shareholders who simply alleged securities law violations that were not patently frivolous could threaten substantial delay in the administration of a corporate bankrupt's estate." *Id.* at 1391.

This Court was satisfied on the facts of *Cartridge Television*, which are not materially different from the facts in the case at bar, that the court below did not abuse its discretion in finding the securities fraud claims to be too contingent and too remote to be allowable under Section 57d.

On the facts in the appeal at bar, the Reorganization Court's order appealed from cannot be held to be an abuse of discretion in finding the Appellants' security fraud claims will unduly delay the administration and liquidation of this estate under Section 57d. (A 444). To require the Reorganization Trustee at this stage of the proceeding to call for the filing of thousands of shareholder "fraud" claims, and to investigate and audit the same, would necessitate an enormous increase in the expense of administration, and result in a considerable and unfair delay to acknowledged creditors receiving their liquidating dividends. The refusal of the Reorganization Court to countenance further delay is not an abuse of discretion with respect to "claimants" who have never filed claims!

*Matter of Weis Securities, Inc.*, 425 F.Supp. 212 (S.D.N.Y. 1977), now on appeal before this Court, is also authority for the District Court's order. *Weis Securities* involved the liquidation of a brokerage firm under the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa, *et seq.* ("SIPA"). Subordinated lenders sought to rescind their loans to *Weis* by reason of its fraud, and sought to share equally in the proceeds of liquidation with general unsecured creditors. Section 6 of SIPA, 15 U.S.C.



§ 78fff, provided for the liquidation of a brokerage firm by a trustee appointed under Section 5(b)(3) (15 U.S.C. § 78eee(b)(3)). SIPA provided that, except as inconsistent with the provisions of the chapter and in the event a plan of reorganization could not be formulated, for the liquidation of the brokerage firm which

“ . . . shall be conducted in accordance with, and as though it were being conducted under, the provisions . . . of Chapter X and such of the provisions of Chapters I to VII, inclusive, of the Bankruptcy Act . . . ”

(15 U.S.C. § 78fff(c)(1))

Judge Wyatt held that while subordinated lenders were entitled to rescind their loans to *Weis* because of its fraud, general unsecured creditors must be paid in full before anything is paid to the rescinding subordinated lenders. He explicitly made his determination on the basis of what fairness and equity would require, saying:

“We must consider, therefore, what equity and fairness would suggest. This seems clearly to be that, as between the customer and other general creditors of *Weis* on the one hand (for whom the trustee speaks) and the subordinated lenders on the other, the agreements of the latter should be enforced according to their terms in distributing the assets of *Weis*. As between *Weis* and the subordinated lenders, the latter are entitled to rescind if fraud is proved; the trustee recognizes this. If the subordinated lenders prove fraud, their claims should be paid before anything is distributed to the stockholders of *Weis*. But the customer and other general creditors of *Weis* should be paid before anything is paid to the subordinated lenders. Every customer and general creditor of *Weis* knew, or is presumed to have known, that the broker-dealer business of *Weis* was regulated by federal law and that as part of such regulation the net capital rule was enforced. The subordinated lenders, by their agreements, enabled *Weis* to comply with the net capital rule and thus to continue in business. The customer and general creditors of *Weis* should therefore

have priority. Under the circumstances, actual reliance is not required to be shown. If the reliance doctrine must be satisfied as a point of dogma, it should be presumed as a matter of law." *Id.* at 217.

If it is "fair and equitable" to compel this result in a SIPA liquidation governed by the principles of Chapter X of the Bankruptcy Act, then by parity of reasoning, it would be "fair and equitable" for a Chapter X plan of reorganization in the nature of a liquidation to subordinate similar *shareholder* "claims" to general creditors.

*Weis* cannot be distinguished, as the Appellants seek to do, upon the ground that brokerage companies are subject to federal regulations (Appellants' Brief, p. 30) for state and at times federal laws regulate corporations in this area. See *Business Corporation Law of New York*, Sec. 513 and Sec. 514.

In *In re Credit Industrial Corporation*, 366 F. 2d 402 (2d Cir. 1966), it was held that proof of reliance upon contractually subordinated debt was unnecessary in order to enforce the subordination in a bankruptcy matter.

In *Weis*, Judge Wyatt stated that reliance should be presumed as a matter of law. If this be the case for subordinated debt, it is submitted that the presumption of creditors' reliance upon the inability of shareholders to compete with them in the assets of an insolvent company is immeasurably greater.

Appellants' attempt to require that this presumption of reliance be based somehow upon a ratio of debt to the equity of a company (see Appellants' Brief, Point II, 37 *et seq.*) has no foundation in law or in common sense. Surely no case so holds. What ratio of debt to capital would this Court establish before the priority of debt over equity in liquidation be determined? Who in this case is to fix such a standard? And on what basis? The argument that there is some magical ratio of debt to equity which must be met before creditors may enjoy a priority over shareholders and shareholder-related claims is devoid of merit.



### 3. The Authorities Generally Do Not Rank Defrauded Shareholders With Other General Unsecured Creditors

At pages 25-30 of their brief, Appellants claim that existing case authorities uniformly rank defrauded shareholders with other general unsecured creditors with respect to an insolvent corporation.

That is not true and we, as the Reorganization Trustee, are at a loss to understand how the Appellants could make such a patently incorrect statement. (See, Reorganization Trustee's Brief, p. 5.)

Indeed, older case law is to the contrary. See, *Scott v. Deweese*, 181 U.S. 202, 213 (1901); *Scott v. Abbott*, 160 Fed. 573, 583 (8th Cir.), cert. denied 212 U.S. 571 (1908); *Carter v. Bogden*, 13 F. 2d 90, 93-94 (8th Cir. 1926); *Hurd v. Kelly*, 78 N.Y. 588, 597 (1879). See also the recent decision in *In re U.S. Financial, Inc.*, 3 Bankr. Ct. Dec. 507 (S.D. Cal. 1977), holding that shareholder rescission and reclamation in a Chapter X proceeding violates the absolute priority rule.

Subordination of shareholder fraud claims to the claims of conventional general unsecured creditors in the assets of an insolvent corporation did not spring, like Venus, from the brows of Messrs. Slain and Kripke.<sup>4</sup>

The advent of the Securities Act of 1933, the Securities Exchange Act of 1934 and state Blue Sky laws, coupled with the contemporary phenomena of shareholder class actions and recent bankruptcies involving major public corporations, have made the issue more recurrent in re-

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<sup>4</sup> See Slain and Kripke *The Interface Between Securities Regulation and Bankruptcy-Allocating The Risk Of Illegal Securities Issuance Between Securityholders And The Issuer's Creditors*, 48 N.Y.U. L. Rev. 261 (1973) and Huff, *The Defrauded Investor In Chapter X Reorganizations: Absolute Priority v. Rule 10b-5*, 50 Am. Bkr. L.J. 197 (1976) for a discussion of this issue and various remedial proposals advanced. We, however, believe that the "absolute priority rule" and the "fair and equitable" standard, absent compromises, compels the subordination of shareholder fraud claims to creditors whose claims are provable under Section 63 of the Act, in a liquidation Chapter X, as in a liquidation bankruptcy.



organization proceedings under the Bankruptcy Act because of the *absence* of fixed rules of law.

The principal authority relied upon by the Appellants, *Oppenheimer v. Harriman National Bank and Trust Company*, 301 U.S. 206 (1937) properly understood, is distinguishable and was rendered before the great wave of securities class actions under the Securities Act of 1933 and the Securities Exchange Act of 1934.

*Oppenheimer* involved a shareholder of a national bank who then being subject to a statutory assessment upon the insolvency of the bank, paid the assessment and was permitted by the Supreme Court to prove a rescission claim against the assets of the bank, *pari passu* with those of general unsecured creditors. The National Bank Act has since been changed and shareholders of national banks are no longer subject to an assessment in respect of the liabilities of an insolvent bank. Query whether if all assessments were paid, the bank was insolvent?

The statutory assessment was similar to a limited guarantee. Before the shareholder in *Oppenheimer* was able to prove his rescission claim, he was obligated to perform his shareholder's duty with respect to the assessment.<sup>5</sup> None of these factors are present in the case at bar. See generally, *Matter of Weis Securities, Inc.*, 425 F. Supp. 212, 217-18 (S.D.N.Y. 1977).

Two cases, relied upon by Appellants, *In re Four Seasons Nursing Centers of America*, 472 F. 2d 747 (10th Cir. 1973) and *Matter of Equity Funding Corp. of America*, 416 F. Supp. 132 (C.D. Cal. 1975) involved *compromises* in connection with plans of reorganizations of viable ongoing corporations.

*Four Seasons* involved an appeal by shareholders who had acquired their shares after the filing of a Chapter X petition (Class E), who complained that defrauded shareholders (Class G), under a compromise settlement approved by a designated multi-panel judge, exhausted the remaining assets (i.e., valuation) of the company to be reorganized.

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<sup>5</sup> See the discussion of *Oppenheimer* in Huff, *supra*, at pp. 210-213, and in Slain and Kripke, *supra*, at pp. 283-286.

Two issues were presented to the Tenth Circuit—first, the contention that the plan erroneously assumed the validity of the unlitigated claims of the Class G claimants, and; secondly, that the Class G creditors should not be treated as creditors for the reason that they were merely another class of shareholders and should be treated as such. 472 F.2d at 748.

Initially, it should be emphasized that the participation of the defrauded shareholders, the Class G claimants, in the plan was the result of a compromise. The Tenth Circuit restated (*Id.* at 749) the broad powers of a reorganization court, as a court of equity, in classifying creditors and shareholders, as well as its full power, to subordinate interests or classes of interests where the equities demanded (*Ibid.*). The compromise between unsecured creditors and Class G shareholders gave the unsecured creditors two-thirds of the equity of the company to be reorganized and the Class G shareholders, one-third. If, as Appellants contend, defrauded shareholders are the same as general unsecured creditors and that the law is absolutely clear on this point, the Reorganization Court would have been in error in not requiring the claims of defrauded shareholders to be classified *pari passu* with those of general unsecured creditors.

Finally, the Tenth Circuit found it neither unfair nor inequitable to effectively wipe out the interests of persons who knowingly became shareholders *after* the filing of a Chapter X petition, and to prefer the pre-petition defrauded shareholders over the post-petition shareholders. The equities of the case would not appear to have justified a different result for that issue.

*Matter of Equity Funding Corp. of America* involved the need for the reorganization court to determine whether a proposed plan, based upon *compromises* between various groups of creditors and defrauded shareholders, was fair and equitable, and feasible, and should be approved. The plan before the reorganization court looked to an ongoing viable corporation, to be reorganized around two insurance subsidiaries.



As with *Four Seasons*, the reorganization court dealt with the scope and extent of review by the reorganization court of compromises which were reflected in the plan under consideration. A compromise had been achieved between Classes 6 and 6.1 general unsecured, unsubordinated creditors and so-called defrauded shareholders who occupied Class 8. The plan gave Class 6 and 6.1 creditors benefits which produced a recovery of between 76.1% to 80% of their claims; Class 8 claims, those of defrauded shareholders, would receive a distribution of equity securities giving them a 12.3% recovery on their claims (at p. 154). Once again, if there is no distinction between conventional general unsecured creditors and so-called defrauded shareholders for the purpose of a Chapter X plan, there would appear to be no basis upon which such a disparity in treatment could legally stand.

*Los Angeles Land and Investment, Ltd.*, 282 F. Supp. 448, *aff'd*, 447 F. 2d 1366 (9th Cir. 1971), is not, as Appellants contend, another example of the *Oppenheimer* rule. In *Los Angeles*, the District Court held that general unsecured creditor classification was to include contract vendees of land having contingent claims arising out of void or voidable sales contracts, to the extent of payments which they made under those contracts plus interest prior to the date of the Chapter X proceeding. The reorganization trustee in *Los Angeles* urged that treatment. The affirmance by the Ninth Circuit Court of Appeals was without opinion, and it does not appear that the District Court either cited or based its decision upon *Oppenheimer*. The District Court simply noted that the contracts were a security as defined in the Securities Act of 1933, and that a liability existed because of misrepresentations under the Securities Exchange Act of 1934, as well as under Blue Sky type laws of the states of Hawaii and California, which granted the purchaser a cause of action for the recovery of his payments plus interest. *Los Angeles* did not involve the claims of *defrauded shareholders*, as the *equity* owners of a corporation, to compete with conventional unsecured creditors on an equal basis in the assets of an insolvent corporation. The contract vendees had contingent but nonetheless liquidated claims, because of the laws



of Hawaii and California. Therefore the claims were provable although the contingency was not exercised until after the filing of the petition. 282 F. Supp. at 452.

*Securities and Exchange Commission v. Insurance Investors Trust Co.*, '71-'72 CCH Fed. Sec. L. Rep. ¶ 93,259 (W.D. Ky., 1971), cited by Appellants at page 29 of their brief, apparently involved the winding up of an unregistered investment company and its subsidiaries in a SEC receivership proceeding. The District Court permitted claims of defrauded shareholders to compete equally with general unsecured creditors in the liquidation proceeds. The most important factor for the District Court was the failure of a single general unsecured creditor to appear before him and contest parity of treatment.

Next, we believe the District Court was totally in error in its third and fourth points ((c) and (d)), when it placed the burden of securities fraud upon conventional unsecured creditors and relied upon equitable considerations of other unspecified avenues of recovery under state laws for creditors to justify the result. The District Court's arcane view that creditors must bear the burden of securities fraud, betrays an antipathy against credit and a predilection that business be done on a cash basis only. If that view prevails, the entire American economy will have to be reorganized. The Reorganization Court here noted that such a view would allow for credit transactions *only upon a secured basis*. The American economy would be the victim, not the beneficiary, of such a view.

Finally, one may well inquire of the District Court why the defrauded shareholders did not have Securities Act claims against the officers and directors of the insolvent company which allegedly defrauded them, as have the Appellants in the appeal at bar, thus balancing out the so-called equities which the District Court perceived by reason of

"... other avenues of recovery available under state law to creditors as against individuals and others alleged by the creditors to have defrauded them in their doing business with the buyer." (at p. 91, 554)

The creditors in the appeal at bar do not assert fraud against Homex; they acknowledge their credit transactions with Homex and urge that their expectations of priority over defrauded shareholders in the assets of the insolvent corporation be upheld. Their only source of recovery, unlike Appellants, is from the assets of this insolvent estate.

To overturn the decision of the District Court in the appeal at bar would simply wipe out the distinction between creditors and shareholders, and require banks, manufacturing companies and all other vendors of goods and services to extend credit to a company on a secured basis only. That is the only remaining means by which creditors can realize their expectations that shareholders, whether or not they were allegedly defrauded, will not compete with them in the liquidation of an insolvent company.

## POINT II

**The Jezarian, Lonetown and Dixon shareholders had no standing before the Reorganization Court, and have no standing before this Court, for they did not timely file claims pursuant to an unambiguous and properly served Bar Order which they admittedly received. They are also guilty of laches in their belated efforts to file claims.**

**Jones and Goldberg claimants did not in fact appear before the District Court and are improperly Appellants in this Court.**

### In Answer to Appellants' Points IV and V

- 1. The Jezarian, Lonetown  
and Dixon Shareholders  
Lack Standing and  
Are Guilty of Laches.**

All of the Appellants except Jones and Goldberg are barred by the doctrine of laches from seeking to file "fraud" claims at this late date.

Laches is a traditional defense in equity actions and has two elements: the failure to assert a known claim or right and detriment to an adverse party by reason of such failure. 2J *Pomeroy Equity Jurisprudence* (5th ed., 1941), 169-181; *Black's Law Dictionary* 1016-17 (4th ed. 1951).



There can be no question that all of the Appellants other than Jones and Goldberg failed to assert a known right for they had commenced a class action based upon the alleged fraud of Homex prior to the filing of the Chapter X petition herein, were shareholders of record throughout the proceedings, and first sought to become "claimants" on June 13, 1977, almost five years after the Chapter X proceeding had commenced. As Slain and Kripke have said (*supra* at 293):

"At a minimum, however, laches should bar a security-holder who knew of the facts underlying his claim substantially before insolvency from competing with any creditors of the enterprise in bankruptcy."

To the same effect, Huff, *supra* at 208-09.

The Banks have irrevocably changed their position to their detriment as a result of their concluded compromise with the Trustee for not only have liens on the bulk of the assets of this consolidated estate been released by the Banks, but they have, as part of the consideration for that settlement, consented to the substantive consolidation desired by the Reorganization Trustee and opposed by the Banks, prior to the settlement.

Moreover, the Banks entered into that settlement upon the representation by the Trustee that priority claims did not exceed \$1,400,000 and general unsecured claims (exclusive of the claims of the Banks and Travelers Indemnity Company) did not exceed \$11,100,000. (A 55). While the Banks protected themselves in the settlement agreement against an increase in general unsecured claims in excess of \$50,168,206 (A 56), it is unseemly for the Appellants to suggest that due to this provision of the settlement agreement between the Banks and the Trustee they will "voluntarily" reduce their claims estimated at \$100 million to approximately \$4,000,000 so as not to exceed the ceiling provided under Section 3.2 of the settlement agreement.

It is spurious to contend that the Bar Order's call for unliquidated and contingent tort claims, such as those of the Jezarians, Lonetown and Dixon, was unclear, excluded such claims or was insufficiently served. Indeed, it is



even a mockery for the Appellants to make such assertions, in view of the allegations of their class actions which had been instituted prior to July 12, 1972 and their status as shareholders of record throughout these Chapter X proceedings.

As to the assertion that the Bar Order explicitly excepted stockholders' fraud claims, we note that language in similar bar orders have been upheld as calling for the filing of so-called fraud claims by shareholders. *Protective Committee v. Anderson*, 364 F. 2d 936, 939 (5th Cir. 1966), *rev'd on other grounds*, 390 U.S. 414 (1967).

By calling for the filing of claims ". . . either in tort or in contract, . . ." the Bar Order went beyond the definition of "claims" set forth in Section 106(1) of the Act so as to leave no doubt that such fraud claims had to be filed.

We read, but cannot comprehend, the argument of Appellants set forth at pages 49-50 of their brief, to the effect that fraud claims by shareholders are "interests" and not "claims." Shareholders have "interests" when they are shareholders and "claims" if they seek to become creditors, as in the case of the Appellants! They do not have "interests" if they pretend to be "claimants." The Appellants would have the best of all possible worlds; they are stockholders for the purposes of the Bar Order and claimants for purposes of distribution. That straddle is both legally incorrect and manifestly unfair.

The Bar Order was properly served and published. Appellants do not cite a single authority in support of their contention that the Trustee was obligated to give any other form of notice to shareholders of record or to former shareholders. None of the cases cited by Appellants at pages 54-55 of their brief so hold. While counsel for the Appellants seemingly acknowledge that "class claims do not lie in this proceeding and while appellants do not pretend to any technical status herein as class representatives," (at p. 19), they are in fact appearing as class representatives and seeking to assert class claims by indirection. Their Rule 10-211 statements acknowledge their alleged representation of classes in these proceedings.

Section 196 of the Act provides that after the approval of the petition, the judge shall prescribe the method and manner and fix a time within which the proofs of claim of creditors and of the interests of stockholders may be filed and allowed.

The new Chapter X Rules, which became effective on August 1, 1975, more than three and a half years after the Bar Order in the present appeal was issued, provide that the general rule that a proof of claim may be filed at any time prior to the approval of a plan does *not* apply, if the court fixes a different bar date, and that if the court does so

"Any person required under this paragraph to file a proof of claim who fails to do so shall not, with respect to such claim, be treated as a creditor for the purposes of voting *and distribution*."

(Emphasis added, Chapter X Rule 10-401(b)(3)(B))

The issuance, text and service of the Bar Order is impervious to attack under the present Chapter X Rules.

Chapter X Rule 10-401(b)(1) provides that if the court determines to fix a different bar date other than prior to the approval of a plan, notice must be given as provided in Chapter X Rule 10-209.

Chapter X Rule 10-209(e) requires notice to be given *by mail* to all creditors and stockholders of the time fixed for filing proofs of claim pursuant to Rule 10-401(b)(1). Notice by mail to stockholders obviously is meant to require notice to shareholders *of record* only for Rule 10-209(d) permits notices to be addressed to such persons at the ". . . address shown in the lists . . ." Notice of the Bar Order to the Appellants was given to them in accordance with the shareholders record maintained by the transfer agent on December 29, 1972.

Finally, with respect to the publication of the Bar Order, Rule 10-209(f) specifically provides for publication

"if the court finds that notice to creditors and stockholders by . . . mail cannot be given *or* that it is desirable to supplement such notice, the court may order publication thereof." (Emphasis added)

In the appeal at bar, the Reorganization Court obviously determined that it would be desirable to supplement mail notice of the Bar Order for its required publication, once during the month of January, 1973, in the *Wall Street Journal* and in the *Rochester Democrat and Chronicle*. The Advisory Committee's Notes to Chapter X Rule 10-209(f) states that Bankruptcy Rule 908 applies when the court directs notice by publication under this Rule.

Bankruptcy Rule 908 provides that

"Whenever these rules require or authorize service or notice by publication, the court shall, to the extent not otherwise specified in these rules, determine the form and manner thereof, including the newspaper or other medium to be used and the number of publications."

In short, the Bar Order would have been effective with respect to the Appellants under the new Chapter X Rules, which specifically and explicitly sanctioned every step undertaken by the Reorganization Trustee. Due Process was complied with unless the Chapter X Rules violate the Constitution of the United States.

The purpose for permitting a reorganization trustee to solicit proofs of claim by a bar order with binding effect upon all persons, is to avoid precisely what has occurred in the appeal at bar. In attempting to deal with creditors, a reorganization trustee must know the amount of the claims of creditors and the basis of their claims (i.e., whether secured or unsecured, tax claims, contingent or unliquidated, contract or tort). The proceedings are then shaped and compromises such as that effected between the Trustee and the Banks concluded, with an eye to the total amount of creditors involved. Indeed, the settlement agreement between the Trustee and the Banks specifically recited the amount of priority and general unsecured claims filed under the Bar Order and the agreement was shaped around those filed claims. (A 55-56, ¶ 3).

While the Advisory Committee's Note to Rule 10-401(b) allows a court some latitude in enlarging the time for filing claims, that latitude should be exercised sparingly,



to avoid injustice, but not as Appellants would have this Court do, so as to permit the arrival on the scene of a so-called class of general unsecured creditors whose claims aggregate \$100,000,000, more than three years after the Bar Order. Particularly, Appellants in the position of shareholders of record should not be heard to urge this result.

In Point V. of their Brief, Appellants argued that due process requires a special call for "shareholder fraud" claims in general, and on the facts of this case, following the Section 167 Report of the Trustee.

On the undisputed facts of this appeal, and on the law, the Appellants are wrong, and they can only urge their own case, not a "class" case.

Firstly, the Bar Order gave proper notice under the then existing statute, as well as the new Chapter X Rules, for the filing of claims by so-called "defrauded shareholders."

Secondly, all Appellants were parties to class actions pending prior to the commencement of Chapter X proceedings for Homex, and the Pomerantz firm was aware of the filing of the Chapter X petition, and as lead counsel therein, was counsel of record for the Jezarians and Lontown. They had full knowledge of the essential facts relating to their allegations of securities law fraud and did not need a Section 167 Report to first inform them about the alleged fraud.

Counsel for the Appellants in the appeal at bar did not need either the Trustee's 167 Report or the Securities and Exchange Commission to inform them of the alleged fraud for they had already instituted class actions based upon the same general facts.

## **2. Jones and Goldberg Have No Standing as Appellants Before This Court.**

While Jones and Goldberg, both as claimants and as shareholders of record, received notice by mail of the hearings held before the District Court on June 13, 1977 (A 149-51), they did not appear at the hearings (A 192-93). Neither Mr. Block's prehearing memorandum, nor his

Attorney's Statement filed under Chapter X, Rule 10-211, claimed any representation of Jones and Goldberg. Jones and Goldberg had retained the Milberg firm (A 30).

Following the hearings before the District Court on June 13, 1977, counsel for the Jezarians and Lonetown realized that he did not represent "claimants" who had filed proofs of claim within the time required by the Bar Order, and in his post-hearing memorandum, he associated Jones and Goldberg and the Milberg firm with his cause. It was apparent that both Jones and Goldberg and the Milberg firm had lost all interest in the proceeding when the class nature of the proof of claim had been stricken on July 24, 1975 (A 44).

A parallel situation in this case occurred when a shareholder, Samuel H. Sloan, who had not appeared at the June 13, 1977 hearings before the District Court, filed a Notice of Appeal from the District Court's orders finding insolvency (A 266) and subordinating claims of defrauded shareholders to claims of conventional general unsecured creditors (A 440). We moved to dismiss Mr. Sloan's appeal and that motion was granted by this Court's Order dated October 25, 1977 (77-5019).

\* The law is well settled that in federal courts only parties to the proceedings below may appeal from an order or judgment entered therein. *United States ex rel. Louisiana v. Jack*, 244 U.S. 397 (1917). In *Jack*, the Supreme Court refused to permit a state to appeal from a judgment rendered against the state's levee district. The Court quoted approvingly of its earlier decision in *Ex parte Tobacco Board of Trade*, 222 U.S. 578 (1911), wherein it was held,

" . . . one who is not a party to a record and judgment is not entitled to appeal therefrom . . ." *Id.* at 581.

This rule applies equally to proceedings in bankruptcy. *In re Inter-City Trust*, 295 F. 495 (1st Cir.), *cert. denied*, 265 U.S. 589 (1924). In *Inter-City Trust*, the Court held that a creditor who was neither a party nor a participant, in the proceeding conducted in the lower court could not appeal from a decision from that court. To the same

effect, *In re Rose*, 86 F.2d 69 (9th Cir. 1936), where the Court held that the rule preventing a person from appealing from proceedings in which the person did not participate applied notwithstanding the fact that the relief sought by the actual parties in the lower court would have inured to the purported appellant's benefit.

A case which is similar to the case at bar is *In re Peppers Fruit Co.*, 24 F. Supp. 119 (S.D. Cal. 1938). There, a bankruptcy trustee filed a petition for leave to compromise two litigations. A hearing was held before the Referee to consider the petition and following the hearing at which various creditors appeared and participated therein, the Referee entered an order approving the compromises. Appeals were filed by several objecting creditors including two creditors who neither appeared at the hearing nor became parties thereto. The District Court dismissed the appeals filed by the two creditors on the ground that they were not proper appellants since they had not appeared and participated in the lower court proceedings. As was held:

"This court feels that, in the interest of economy and efficiency of administration of bankrupt estates, reviews from referees' orders, at least those orders which are made after notice, should be limited to applications by parties *who have appeared at the hearing before the referee and participated therein*. Any other holding would leave the door open to a flood of reviews which would result not only in delay and expense, but would place an almost intolerable burden upon the district judges." *Id.* at 121-22. (Emphasis added)

See also, 2A *Collier on Bankruptcy* ¶ 39.19, at 1496-97 (14th ed. 1977), wherein it was said,

"Whenever matters are thus heard upon notice, appeals of orders are limited to applications by parties who have appeared at the hearing before the referee and participated therein."

One does not become a party to a proceeding or participate therein by post-hearing "association", which in reality is afterthought.



We think the position of all of the Appellants is parallel to that described in *In re Mifflinburg Body Co.*, 54 F.Supp. 560, 561 (M.D. Pa. 1944), where the District Court said:

“ ‘Whenever matters are thus heard upon notice, reviews of orders are limited to applications by parties who have appeared at the hearing before the referee and participated therein.’ 2 Collier on Bankruptcy, 14th Ed., p. 1480; Matter of Peppers Fruit Co., D.C., 24 F.Supp. 119; see also Matter of Rose, 9 Cir., 86 F.2d 69.

The reason for this rule is clear. When a party to litigation receives notice that a matter will be heard, it is his duty to appear at the hearing and present to the court evidence and legal authorities which will be of aid to the court in making its decision. If he does not do so, the court must make its decision without the benefit of any evidence which such person might have made available, and the court must act upon the presumption that persons who are absent are not interested in the matter before it or will be satisfied with such decision as the court may make. To permit persons who did not participate in proceedings of which they are on notice to complain of the result of such proceedings would cause unlimited confusion and even disrespect of the courts and their authority.

It is also well settled that a petition for review may not be filed by an attorney at law who has no interest in the proceedings except as the representative of clients. 2 Collier on Bankruptcy, 14th Ed., p. 1480, and cases there cited.

*An attorney has no interest in a proceeding except as a representative of his clients. His actions in any proceeding must appear to be the actions of his clients through him. This is particularly important in bankruptcy cases where the temptation is for lawyers to prolong litigation and harass the officers of the court for the purpose of procuring some special advantage.*” (Emphasis added)

### POINT III

**None of the Appellants raised the contention before the District Court that the Banks' claims should be equitably subordinated to shareholder fraud claims. They are foreclosed from raising such assertion on this appeal.**

#### **In Answer to Appellants' Point III**

In Point III of their Brief, the Appellants urged that the claims of the Banks should be equitably subordinated to "fraud claims" of the preferred stockholders and to "many" of the fraud claims of the common stockholders. (We note that only Jones and Goldberg have filed "fraud" claims at this time).

As we apprehend their argument, Appellants contend that Chemical Bank is alleged to have aided, abetted and conspired in the issuance of a materially false Registration Statement and Prospectus, and that "all" of the Banks are answerable as principals for a fraud perpetrated by Chemical Bank within the scope of an alleged "agency" (p. 44). The Appellants have a remedy in their class action to which Chemical Bank has been made a defendant *if* they prove those allegations.

These contentions have been raised by the Appellants for the first time on this appeal, are an evident afterthought and betray an intemperate anger at the result which occurred in the District Court. In reality, the contentions seek to impeach and collaterally attack the unappealed settlement between the Banks and the Trustee, which produced the major portion of the estate available for distribution to unsecured creditors. That settlement was approved after a full, non-perfunctory hearing before Bankruptcy Judge Hayes (A 61) who issued his Findings of Fact and Recommendations to the District Court (A 108) which in turn, following a hearing, entered its Order dated June 29, 1976 confirming the report, approving the settlement and *allowing the claims of the Banks as unsecured*

creditors (A 142-45).<sup>6</sup> The hearings on the settlement before the Bankruptcy Judge, to whom the matter had been referred by the District Court to hear and report, was commenced on notice by mail to all creditors and shareholders (as of December 31, 1973): all of the Appellants, as shareholders of record on December 31, 1973, received notice of the hearings on the settlement and none of them appeared before Bankruptcy Judge Hayes on May 10, 1976 (A 62-63).

In his objections to the claims of the Banks, the Trustee had contended that not only should the Banks' liens be avoided, but that they should be subordinated to other unsecured creditors. In his testimony at the settlement hearings, the Trustee candidly characterized that relief as

"... a very dubious request on our part, it's perhaps a litigating lawyer's distemper to go for the extreme, but I think that no one has taken us too seriously with that request . . ." (A 93)

It is undoubtedly pointless to expect the same candor on the part of the Appellants.

It has long been the law that the Court of Appeals will not consider arguments which appellants failed to raise in the District Court. *Libbey-Owens-Ford Glass Co. v. Sylvania Industrial Corporation*, 154 F.2d 814 (2d Cir.), cert. denied, 328 U.S. 859 (1946). In *Libbey, supra*, Judge Clark considered a contention that was raised for the first time by the appellants before the Second Circuit and held:

"This is an afterthought not presented below and should not be considered now. . . ." *Id.* at 816.

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<sup>6</sup> For the statutory basis for compromises, see Bankruptcy Act, Section 27: "... the trustee may with the approval of the court compromise any controversy arising in the administration of the estate upon such terms as he may deem for the best interest of the estate." Chapter X Rule 10-299(b)(2) requires that at least twenty days notice by mail to all creditors and shareholders of hearings for the approval of a compromise or the settlement of a controversy. The notice of the trustee was sent by mail to all creditors and shareholders of record as of December 31, 1973 and gave more than twenty days notice.



The application of the rule which forecloses appellate consideration of issues not raised below is particularly apt in this appeal since a claim for equitable subordination to shareholders is a calculated effort to cloud the real issues on appeal and to belatedly attack the Trustee's settlement with the Banks and the allowance of their claims.

"An appellate court . . . will . . . [not] permit a party to allege on appeal what it failed to claim to the trial court. To do so would allow a party to obtain a new trial simply on its claim that it would have proven a certain fact or facts had it been given a chance." *Fortunato v. Ford Motor Company*, 464 F.2d 962, 967 (2d Cir.), *cert. denied*, 409 U. S. 1038 (1972).

See also Weiner, *Briefing and Arguing Federal Appeals*, 403 (1967 Ed.).

### CONCLUSION

**For all of the reasons set forth herein, it is respectfully submitted that the order appealed from be affirmed in all respects.**

Respectfully submitted,

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(62565)



# United States Court of Appeals

For the Second Circuit

In the Matter of

STIRLING HOMEX CORPORATION, *Debtor*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for Mark Goldberg, and MRS. D. WINDSOR DIXON,

*Appellants,*

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; and THE TRAVELERS INDEMNITY COMPANY,

*Appellees.*

Appeal from the United States District Court  
for the Western District of New York

State of New York,  
County of New York,  
City of New York—ss.:

Thomas D'Esposito

being duly sworn, deposes

and says that he is over the age of 18 years. That on the 30th day of January, 1978, he served two copies of the Brief of Appellees Chemical Bank and The First National Bank of Chicago on - see attached list

the attorneys for ~~the~~ see attached list

by depositing the same, properly enclosed in a securely sealed post-paid wrapper, in a Branch Post Office regularly maintained by the Government of the United States at 90 Church Street, Borough of Manhattan, City of New York, directed to said attorney s at No. See attached list ( ) N. Y.,

that being the address designated by them for that purpose upon the preceding papers in this action.

*Thomas D'Esposito*  
.....

Sworn to before me this

30th day of January, 1978

*Courtney J. Brown*  
COURTNEY J. BROWN

Notary Public, State of New York

No. 31-5472920

Qualified in New York County

Commission Expires March 30, 1978



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